Second Quarter 2015 Financial Market Commentary

July, 2015

Slower and Lower for Longer

During the second quarter investors focused on when the Federal Reserve would begin to raise interest rates for the first time since June 2006. With mixed U.S. economic data following a first quarter weather-induced slowdown and dubious ongoing debt negotiations in Greece, stocks finished slightly positive while bonds posted their first quarterly loss since 2013.

On June 17th, at the conclusion of the two day Federal Open Market Committee (FOMC) meeting, ***the Federal Reserve said that while interest rates will likely rise this year, the pace of any tightening will be gradual as officials wait for evidence of a more robust economic recovery.*** Following the Fed statement, stocks and bonds both rallied as financial markets bet the Fed would increase interest rates at a slower pace, with a lower trajectory over a longer period of time than the Fed's previous economic forecast suggested. However, after negotiations between Greece and its primary creditors broke down late on June 26th, concern over the fallout resulted in a sharp sell-off in most risk-based assets.

The top performing asset class for the quarter was Commodities thanks to a 15% rise in the price of oil and a 3% drop in the value of the U.S. dollar. U.S. Large Cap, Small Cap, International Developed, and Emerging Markets stocks along with High Yield bonds generated slightly positive total returns **(See Tables #1 & #2)**.

All primary bond sectors generated negative total returns during the quarter. German bund yields spiked as a result of better than expected Euro area economic data which reduced the relative attractiveness of U.S. Treasuries. Chinese monetary authorities introduced additional stimulus measures which lowered the risk of a hard economic landing and reduced the safe-haven appeal of Treasuries. Oil prices underwent a bear market rally which served to lift inflation expectations. All of these factors contributed to the sell-off in U.S. bond prices/yield increases. Bond prices and yields are inversely related. Going forward, we don't expect these factors to further pressure U.S. bond prices lower/yields higher. We expect Euro area growth to struggle and the bear market in oil to resume as ***ultra-low interest rates will continue to be needed throughout the developed world in order for the global economy to grow.***

TABLE #1: 2015 2nd Quarter and 1 Year Ending June 30th - Asset Class Index Returns*

	Large Cap Stocks	Mid-Cap Stocks	Small Cap Stocks	Int'l Stocks	Emerging Stocks	Intermediate Bonds	High Yield Bonds	Real Estate (REITs)	Preferred Stocks	Commodities	Cash
2Q 2015	**0.29%**	**-1.06%**	**0.42%**	**0.83%**	**0.83%**	**-0.56%**	**0.09%**	**-9.06%**	**-1.13%**	**8.73%**	**0.01%**
1YR 6/30/15	**7.41%**	**6.37%**	**6.48%**	**-3.54%**	**-4.81%**	**1.79%**	**-0.84%**	**4.14%**	**5.31%**	**-36.81%**	**0.02%**

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TABLE #2: 2015 2nd Quarter and 1 Year Ending June 30th – Bond Sector Index Returns*

	U.S. Treasuries 1-10yr	U.S. Agencies 1-10yr	Corporate Bonds 1-10yr	Mortgage-Backed Securities (MBS) 0-10yr	Municipal Bonds 1-10yr
2Q 2015	-0.47%	-0.06%	-0.85%	-0.79%	-0.40%
1 YR 6/30/15	1.93%	1.65%	1.57%	2.16%	1.25%

*Source: Bloomberg and Bank of America/Merrill Lynch Indices

In her statement following the conclusion of the June 17th FOMC meeting, Fed Chair Janet Yellen noted that "since the committee met in April, the pace of job gains has picked up and labor market gains have improved further." Yet, she said that the pace of any tightening (interest rate increases) would be gradual. The timing of an interest rate increase depends upon how the economic data unfold. She also mentioned that the trajectory of rate increases should matter more to markets than the actual liftoff date. ***Our take is that while the economy is improving, it is not improving fast enough to force the Fed to raise interest rates quickly. In addition, how the turmoil in the euro zone plays out may also influence if/when the Fed tightens monetary policy later this year.***

At the June 17th FOMC meeting the Fed maintained its forecast for the overnight Fed Funds rate to rise to 0.625% this year, but lowered its projection for next year to 1.625% from 1.875%. Job growth has been strong but inflation has remained below the Fed's 2% target rate. Their preferred measure of inflation, the Personal Consumption Expenditure Index - excluding food and energy, currently stands at 1.2% on a year-over-year basis. ***We believe that the rate of inflation is the most important economic indicator for determining the timing and magnitude of future interest rate increases.***

Right now, with job vacancies the highest on record and the unemployment rate at 5.5%, one would think that inflation – led by wage increases, is about to take off. However, millions of Americans that are working part-time but want full-time work and those who aren't looking for work but want a job aren't counted as unemployed. They are counted in the U-6 "Underemployment" Rate which currently stands at 10.8%. Eventually, as economic growth begins to accelerate, the labor market and wage gains should continue to improve and ultimately lead to higher inflation expectations. This may still be several months or years away from occurring.

As for the very fluid situation in Greece, we still believe it is by far, in the best interests of both the EU (European Union)/IMF (International Monetary Fund) and Greece to reach an agreement. However, at the time of writing this commentary, negotiations have broken down. Greece is running out of cash, capital controls have been put in place as all Greek banks have been closed until July 6th. Talks over bailout aid with international creditors collapsed late on June 26th, as Prime Minister Alexis Tsipras unexpectedly called a July 5th referendum on the austerity demanded by creditors. Tsipras essentially punted the decision to accept or reject the EU's aid proposal over to the citizens of Greece. The European Finance Commission offered Greek voters a 10-point plan for bailout requirements on June 28th, urging Greece to stay in the euro area. The bailout expired on June 30th as a $1.7 billion payment was due to the IMF that went unpaid. The Greek government asked for a two year bailout program and asked the ECB to extend emergency financing. German Chancellor Angela Merkel said there would be no negotiations until after the July 5th Greek referendum. It's up to the Greek government and people to step back from the brink and stay in the EU. The key date is July 20th when a 3.5 billion euro payment is due to the ECB by Greece. This date will likely force the ECB to make a permanent decision on supporting Greek banks via the emergency liquidity assistance program or pulling the plug on Greece.

If Greece were to leave the EU, chaos surrounding a currency switch to the drachma from the euro would be tremendous. We're not sure that Greece could even launch a new currency and pull off an orderly exit. Future financing would be nearly impossible to obtain if they walk away from the 240 billion plus euros of current funds owed to creditors. Living standards would plummet. The drachma would instantly fall in value by 50% or more. Businesses would suffer greatly along with the government. Inflation could surge and capital controls would be put in place. Bank deposits would be frozen and future pension payments would be in the form of IOUs because the government and companies would run out of money temporarily. A Greek exit would be a nightmare scenario and no one really knows for sure how it would play out. Leaving the EU would be an incalculable economic risk for Greece.

As for the rest of the EU, the risks of a Greek exit for the entire euro zone are manageable and the ECB would use all measures at its disposal to defend the currency union. The IMF has praised the EU for building a "fire wall" to prevent Greek exit-related turbulence from spreading to other countries. Countries on the periphery of the euro zone are no longer as susceptible to risk as they were during the outbreak of the euro zone problems in 2010. Greece doesn't seem to represent the threat to the global economy that it did just a few years ago. Most of Greece's debt is now held by other governments and the International Monetary Fund, not other banks. That helps contain some of the fallout and would not lead to any threat of a market crash.

A deal to keep Greece in the EU can happen in the next few weeks. It is by far the best option for all parties involved. The citizens of Greece are getting a taste of what life would be like outside the euro zone in the days leading up to the July 5th referendum with capital controls, closed banks, and shortages of food and fuel. Hopefully this experience will motivate the majority of Greeks to vote for the bailout proposal. In the meantime, short-term market volatility will be on the rise as the situation plays out. We are anxiously watching the daily events and will send out an update to clients when there is something of significance to report.

No major tactical changes to asset allocation strategies were made during the quarter. We continue to believe that due to aging demographics, high debt/growth ratios, and technological advancements displacing labor, global economic growth will struggle to climb above 3% over the next year. As a result, inflation, interest rates, and bond yields will remain low and stocks, particularly those that pay dividends, should outperform bonds and cash. The Fed will be slow to raise interest rates for fear of weakening a fragile global economy that is trying to grow in the face of the aforementioned headwinds.

Concerns about the longevity of the six-year bull market have grown this year as the economic recovery matures and U.S. stocks trade sideways. However, we believe that the economic recovery in the U.S. and the stock market's run still has room to go higher. Exceptionally low interest rates around the globe are a key reason why we expect positive returns to continue in many countries. Low rates will continue to force money into riskier but potentially higher-returning investments such as stocks.

While the S&P 500 Index on a Shiller P/E ratio basis (27.12) looks rich, it can become even richer as long as interest rates and inflation remain relatively low. Using only valuation metrics as a way to determine market turning points has never worked. Like the British economist John Maynard Keynes said "The market can stay irrational longer than you can stay solvent." A slow and low growing economy with low inflation and Fed support can send stock prices even higher than current levels.

Bull markets do not die of old age. They usually end because of an economic contraction/recession. At present, none of the typical recession signals are flashing. The bond yield curve remains steeply-sloped with 10 Year U.S. Treasury Notes yielding 171 basis points more than 2 Year U.S. Treasury Notes. This spread usually narrows or becomes negative before a recession. Consumer spending in May climbed by the most since August 2009 thanks to gains in income as the U.S. job market strengthened. Job growth has remained steady averaging monthly gains of 255,000 jobs over the past year. The Consumer Confidence Index recently rose above 100 for the first time since 2007. Growth in manufacturing has been sustainable with the monthly index of purchasing managers remaining in expansionary territory since January 2013. There is a lack of significant global imbalances and signs of overextension that typically lead to a bear market. Pre-2008 reliance upon short term debt and derivative securities that made the financial system so vulnerable is much lower now. Lastly, the banking system has significantly boosted its capital positions and liquidity levels. As a result, we believe the 6+ year and running bull market in stocks should remain intact.

Low inflation, healthy consumer finances, and pent-up demand for housing help support the case that the current economic recovery can withstand any fallout from Greece. The key to prolonging the economic expansion will be the ability of the Fed to raise interest rates from historical lows without upending the financial markets and dampening growth. ***We believe that the Fed is very aware of the risks of tightening monetary policy prematurely.*** The futures markets are forecasting the first rate increase will occur at the December 16th FOMC meeting. As we approach this date, stock and bond market volatility may be on the rise. However, Fed policy should remain very accommodative even as interest rates start to ***gradually*** rise. We believe that global stocks should continue to outperform bonds and cash. Corporate earnings should rise as economic growth improves. For now, we are keeping broad asset allocations in stocks, bonds, & cash close to their strategic targets and are looking for tactical opportunities in stock markets in the U.S. and abroad.

Andrew Zimmerman – Chief Investment Strategist

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Notes: The DT Investment Partners' Commentary and Outlook discusses general developments, financial events in the news and broad investment principles. It is provided for information purposes only. The material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Investments in various asset classes entail different investment risks. For example, small cap stocks tend to be more volatile than large or mid-cap stocks. International and emerging markets stocks have exposure to currency fluctuations, foreign taxes, political instability and the possibility for illiquid markets. Fixed income investments involve interest rate and credit risks among others. Real estate investing includes risks such as declines in value of real estate, changing economic conditions, tax laws or property taxes. Commodities' investing is highly volatile and subject to changing economic conditions and the vagaries of speculators among other risks. Further, diversification and strategic or tactical allocation do not assure profit or protect against loss in declining markets. Index performance returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index. Past performance does not guarantee future results.